



**PADGETT LAW, P.A.**  
WE HELP YOU KEEP WHAT'S YOURS

## S CORPORATION

### Formation

---

An S corporation is organized under the usual state law corporate formation requirements. When organized, an S corporation ordinarily is not specially designated as an S corporation for local law purposes, but achieves S corporation status for federal income tax purposes by making a Subchapter S tax election. All shareholders of the corporation must consent to this election. The effect of the S corporation election is that generally there is no federal income tax imposed at the entity level. All corporate income is treated as currently received by the shareholders without regard to whether that income actually is distributed. To be eligible for S corporation status, the corporation:

- ◆ must be a domestic corporation;
- ◆ may not be a financial institution that uses the reserve method of accounting for bad debts; an insurance company, a §936 corporation, or a DISC or former DISC;
- ◆ must not have more than 100 shareholders;
- ◆ generally must not have a shareholder that is not an individual;
- ◆ must not have any nonresident alien shareholders; and,
- ◆ must not have more than one class of stock.

### Operation & Management

---

For state law purposes an S corporation is formed and operated like any other corporation.

### Taxation

---

An S corporation is not generally subject to income tax; rather, the income or losses are allocated to the shareholders on a pro rata basis in relation to their ownership percentages, in much the same manner as partners are taxed with respect to their ownership in a partnership. The tax character of any item allocated to a shareholder is determined as if the item were received directly from the source from which realized by the corporation. If a C corporation elects S corporation status, any later recovery of prior year C corporation tax benefit items is passed through to the S corporation shareholders and included in the shareholders' taxable income.

### Sale of S Corp Stock

---

An S corporation shareholder may sell his or her shares in the corporation to a third party. To the selling shareholder, the tax basis for the S corporation shares sold will previously have been increased for the income items which have flowed through the corporation to the shareholder and will have been decreased for distributions to the shareholder and for items of loss and deduction.